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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA, *Petitioner,*

—v.—

ARTHUR YOUNG & COMPANY

—and—

AMERADA HESS CORPORATION, *Respondents.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF *AMICI CURIAE* OF ARTHUR ANDERSEN & CO., ALEXANDER GRANT & COMPANY, COOPERS & LYBRAND, DELOITTE HASKINS & SELLS, ERNST & WHINNEY, PEAT, MARWICK, MITCHELL & CO., PRICE WATERHOUSE, SEIDMAN & SEIDMAN AND TOUCHE ROSS & COMPANY IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*

This brief in support of respondents is submitted, with the consent of all parties, on behalf of Arthur Andersen & Co., Alexander Grant & Company, Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat, Marwick, Mitchell & Co., Price Waterhouse, Seidman & Seidman and Touche Ross & Co. as *amici curiae*.

The *amici curiae* are firms engaged in the practice of the profession of accounting. They perform the same audit function as is performed by respondent Arthur Young & Company. They share with that firm the concern that their audit clients not be inhibited in communicating to them the clients' thinking concerning tax liability and strategy for the resolution of tax disputes.

The *amici curiae* believe that a brief presentation of their analysis of the issue can assist the Court in its consideration of whether auditors' tax accrual workpapers should be protected by a qualified privilege when production of the workpapers is sought by a summons under I.R.C. § 7602.

SUMMARY OF ARGUMENT

The court of appeals protected tax accrual workpapers from IRS discovery because discovery of taxpayer thinking and an auditor's evaluation of its client's tax liability would tend to compromise the procedure designed by Congress to protect the investing public from inaccurate financial information and is not needed by the IRS, which has access to the transactional data. Since the protection is a qualified privilege against discovery of thoughts and conclusions, not evidence, it does not create a client-accountant privilege for transactional data or contradict the principle that the public has a right to every man's evidence. It does, however, properly reject "considerations of [IRS] convenience." *Upjohn* v. *United States*, 449 U.S. 383, 396 (1981).

The qualified privilege fashioned by the court carries out the "general mandate" of Rule 501 of the Federal Rules of Evidence that the courts "continue the evolutionary development of . . . the law of privilege." *Trammel* v. *United States*, 445 U.S. 40, 47 (1980). It accords with "reason and experience." Fed. R. Evid. 501.

The Section 7602 summons provides the occasion for, but not the answer to, the question of whether tax accrual workpapers should be protected by a qualified privilege. Enforcement

of Section 7602 is limited by privilege, including such a qualified privilege as that of *Hickman* v. *Taylor*, 329 U.S. 495 (1947), for the thinking of an attorney. *Upjohn Co.* v. *United States*, *supra*.

The qualified privilege obviates the substantial constitutional question that would be presented if self-questioning by the taxpayer were added to the self-reporting tax system by way of IRS discovery of tax accrual workpapers. Unfairness as between Government and taxpayer and governmental prying into private thought implicate the Bill of Rights. *Cf. First National Bank* v. *Bellotti*, 435 U.S. 765 (1978).

ARGUMENT

TAX ACCRUAL WORKPAPERS SHOULD BE PROTECTED FROM SECTION 7602 DISCOVERY BY A QUALIFIED PRIVILEGE

The court of appeals protected tax accrual workpapers from discovery by the IRS because:

> — the auditor's inquiry of its client, which is recorded in the tax accrual workpapers, "lays bare" the "basic thinking" of the client as a taxpayer, including settlement positions and strategy;
>
> — the prejudice to the client of permitting IRS discovery of the client's thinking as recorded in the workpapers is such that "a prudent organization might not be perfectly candid with independent auditors";
>
> — such an inhibition upon client candor "compromises the procedure designed by Congress to protect the investing public from inaccurate financial information";
>
> — absent allegations of fraud, the IRS "does not need to know [a] taxpayer's thoughts"; and
>
> — the "corporation's own books and the audit workpapers furnish the IRS with all the raw data that it needs to calculate the taxpayer's tax liability." (677 F.2d at 220.)

The Court also noted the proposal of former Commissioner Kurtz that "taxpayers flag their questionable positions directly on their returns . . . ." (677 F.2d at 221), but said that "[p]rocuring tax accrual workpapers under Section 7602 seems to us to effectuate Commissioner Kurtz' proposals through the back door." (677 F.2d at 221.)

Congress has chosen a different approach—an approach that does not intrude upon the candid communication between client and auditor that is essential to the audit function. In I.R.C. § 6661, which was enacted after the decision below, Congress provided for a surcharge of 10% of the underpayment attributable to a substantial understatement of tax due unless (tax shelters aside) there is substantial authority for the taxpayer's treatment of any item or the relevant facts are adequately disclosed by the taxpayer. Congress thus left disclosure of the tax treatment of particular items to the taxpayer (not the auditor) with the impetus of a possible surcharge.

As ultimately recognized by the Government at page 35 of its brief, the court of appeals "focused on fostering candid communications from client to accountant." The court did so to protect the disclosure process mandated by the federal securities laws, while also providing to the IRS the evidence needed by it to determine the correctness of the client's tax return.

The court likened its protection of the tax accrual workpapers to the work-product privilege fashioned in *Hickman* v. *Taylor, supra*. As with that privilege, the protection accorded the tax accrual workpapers is qualified. It may be overridden by a sufficient showing of need (677 F.2d at 221)—but when the case does not involve allegations of fraud, the convenience to the IRS of "a roadmap of the thoughts and theories of a taxpayer and its independent auditor" does not suffice. (Id. at 220.)

As in *Hickman*, the protection of the tax accrual workpapers is not a testimonial privilege, but a discovery privilege.[1] It

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1 It follows from protection of the tax accrual workpapers that the IRS may not obtain access to the same subjective thoughts by summoning the testimony of the auditor who created the workpapers.

protects a subjective "roadmap." It does not deprive the IRS of the evidence upon which to base or compromise a claim of tax liability.

Protection of tax accrual workpapers does not create an absolute "accountant-client privilege" such as was referred to in *Couch* v. *United States*, 409 U.S. 322, 335 (1973), where the issue was not protection of the thinking of the taxpayer but rather production of the taxpayer's "bank statements, payroll records, and reports of sales and expenditures" which the taxpayer had given to her accountant. (409 U.S. at 324.) Since the qualified privilege protects thoughts, not evidence, it does not contradict the principle that " 'the public . . . has a right to every man's evidence.' " *Trammel* v. *United States*, *supra*, 445 U.S. at 50 (1980). These are the straw men of the Government's argument: *Couch* is cited nine times (Gov't Br. 5, 9, 11, 14, 28, 32, 35, 36, 38).

It is the convenience of the IRS, not evidence needed to ascertain the correctness of tax returns, which is at the heart of the Government's argument. Protection of tax accrual workpapers properly rejects "considerations of convenience." *Upjohn Co.* v. *United States*, *supra*, 449 U.S. at 396.

A. The Privilege Carries Out the Mandate of Rule 501

Rule 501 of the Federal Rules of Evidence is a "general mandate" to the courts "to continue the evolutionary development of . . . the law of privilege." *Trammel* v. *United States*, *supra*, 445 U.S. at 47. "[T]he recognition of a privilege based on a confidential relationship and other privileges should be determined on a case-by-case basis." S. Rep. No. 1277, 93d Cong., 2d Sess. 13 (1974), *reprinted in* 1974 U.S. Code Cong. & Ad. News 7051, 7059.[2]

As the rule provides, the courts are to carry out this mandate "in the light of reason and experience." *Id.* at 11, 1974 U.S.

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2 *Couch* was decided before the adoption of Rule 501 of the Federal Rules of Evidence.

Code Cong. & Ad. News at 7058. "[A] federally developed common law based on modern reason and experience shall apply. . . ." *Id.*

The privileges contemplated by the rule extend to persons and situations beyond the testimony of a witness. "The words 'person, government, State, or political subdivision thereof' were added by the Committee to the lone term 'witnesses' used in Rule 26 [of the Federal Rules of Criminal Procedure] to make clear that, as under present law, not only witnesses may have privileges." H.R. Rep. No. 650, 93d Cong., 1st Sess. 8-9 (1973), *reprinted in* 1974 U.S. Code Cong. & Ad. News 7075, 7082.

The protection fashioned by the court of appeals for tax accrual workpapers protects a "person"—the independent auditor—against discovery of its recording of its own evaluations and the tax thinking—not the transactional data—of its client. Workpapers reflecting the audit of underlying transactions, in contrast to the auditor's assessment of the adequacy of the tax reserve, are not protected by the ruling of the court of appeals.

The protection of thinking accords with reason and experience. It recognizes that permitting discovery by the IRS of the client's thinking may lessen the candor with which the client communicates with the independent auditor and thus compromise the effectiveness of the audit function performed by independent accountants as is required by the federal securities laws.[3] The IRS has access to the client's transactional data. The qualified nature of the privilege responds to the needs of the IRS, but not to its convenience.

B. Enforcement of a Section 7602 Summons is Limited by Privilege

Without Section 7602, there would be no authority for discovery by the IRS of any of the workpapers of an indepen-

3 The importance of client candor and audited financial statements is not restricted to the financial statements called for by federal law.

dent auditor. The statute provides the occasion for, but not the answer to, the question of whether tax accrual workpapers should be accorded the protection of a qualified privilege.

Section 7602 does not provide the "complete latitude to the summons power that the IRS seeks here . . . ." (677 F.2d at 220.) Enforcement of a Section 7602 summons is subject to limits, and one such limit is privilege. *United States* v. *Euge*, 444 U.S. 707, 712 (1980).

The privilege need not be ancient or absolute. The protection for the thinking of an attorney which the Court fashioned in *Hickman* v. *Taylor*, *supra*, and upon which the court of appeals patterned its protection for the thinking of a taxpayer is just such a limit upon a Section 7602 summons. *Upjohn Co.* v. *United States*, *supra*.

C. The Privilege Obviates a Substantial Constitutional Question

The qualified privilege for tax accrual workpapers properly weighs the process designed by the federal securities laws to protect investors against materially misleading finanical statements against the convenience of the IRS in examining tax returns. The rights of the taxpayer under a self-reporting tax system figure in a broader equation and support the privilege.

The majority below recognized that "requiring the taxpayer alone to disclose settlement positions would improperly weight the balance [in negotiations between the taxpayer and the IRS]." (677 F.2d at 220.) The dissenting judge noted that whether "sweeping self-questioning" by taxpayers "can or should" be added to the self-reporting tax system is "fairly debatable." (677 F.2d at 224 n.8, Newman, J., dissenting in part.)

The Court has held that to obtain judicial enforcement of a § 7602 summons the IRS "must show," among other things, that its investigation has a legitimate purpose and that the information sought is not already within its possession. *United States* v. *Powell*, 379 U.S. 48, 57-58 (1964). Already having

possession of the taxpayer's transactional data, the IRS cannot make the required showing unless in ascertaining the correctness of the tax returns when fraud is not alleged the IRS is entitled, not only to the facts, but also to the taxpayer's and auditor's thoughts concerning the facts.

To require that, in addition to accurate factual statement and honest judgment, a taxpayer direct the IRS to particular areas of inquiry smacks of unfairness as well as Government prying. Unfairness between the Government and private persons and governmental prying into private thought implicate the Bill of Rights. *Cf. First National Bank* v. *Bellotti, supra.*

• • •

CONCLUSION

The judgment of the court of appeals insofar as it reversed the district court's order that the tax accrual workpapers be produced should be affirmed.

Respectfully submitted,

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